

1996
Executive Research Project

**The Federal Reserve System:
Strategic Asset in the Info-Technology Age
of the 21st Century**

Commander
Charles F. Webber
U.S. Navy

Faculty Research Advisor
Dr. Hugh E. Conway



The Industrial College of the Armed Forces
National Defense University
Fort McNair, Washington, D.C. 20319-5062

19961001 009

DISTRIBUTION STATEMENT A

Approved for public release;
Distribution Unlimited

REPORT DOCUMENTATION PAGE

1a. REPORT SECURITY CLASSIFICATION. UNCLASSIFIED			1b. RESTRICTIVE MARKINGS			
2a. SECURITY CLASSIFICATION AUTHORITY N/A			3. DISTRIBUTION/AVAILABILITY OF REPORT Distribution Statement A: Approved for Public Release: distribution is unlimited.			
2b. DECLASSIFICATION/DOWNGRADING SCHEDULE N/A						
4. PERFORMING ORGANIZATION REPORT NUMBER(S) NDU-ICAF-96-			5. MONITORING ORGANIZATION REPORT NUMBER(S) N/A			
6a. NAME OF PERFORMING ORGANIZATION Industrial College of the Armed Forces		6b. OFFICE SYMBOL (If applicable) ICAF-FA		7a. NAME OF MONITORING ORGANIZATION National Defense University		
6c. ADDRESS (City, State, and ZIP Code) Fort McNair Washington, D.C. 20319-6000			7b. ADDRESS (City, State, and ZIP Code) NDU-LD-SCH Ft. McNair Washington, D.C. 20319-6000			
8a. NAME OF FUNDING/SPONSORING ORGANIZATION N/A		8b. OFFICE SYMBOL (If applicable)		9. PROCUREMENT INSTRUMENT IDENTIFICATION NUMBER N/A		
8c. ADDRESS (City, State, and ZIP Code)			10. SOURCE OF FUNDING NUMBERS			
			PROGRAM ELEMENT NO.	PROJECT NO.	TASK NO.	WORK UNIT ACCESSION NO.
11. TITLE (Include Security Classification) <i>The Federal Reserve System: Strategic Asset in the Information Age of the 21st Century</i>						
12. PERSONAL AUTHOR(S) <i>Commander Charles J. Webber, USN</i>						
13a. TYPE OF REPORT Research		13b. TIME COVERED FROM Aug 95 TO Apr 96		14. DATE OF REPORT (Year, Month, Day) April 1996		15. PAGE COUNT 22
16. SUPPLEMENTARY NOTATION						
17. COSATI CODES			18. SUBJECT TERMS (Continue on reverse if necessary and identify by block number)			
FIELD	GROUP	SUB-GROUP				
19. ABSTRACT (Continue on reverse if necessary and identify by block number) See Attached						
20. DISTRIBUTION/AVAILABILITY OF ABSTRACT <input type="checkbox"/> UNCLASSIFIED/UNLIMITED <input checked="" type="checkbox"/> SAME AS RPT. <input type="checkbox"/> DTIC USERS				21. ABSTRACT SECURITY CLASSIFICATION UNCLASSIFIED		
22a. NAME OF RESPONSIBLE INDIVIDUAL Susan Lemke				22b. TELEPHONE (Include Area Code) (202) 685-3957		22c. OFFICE SYMBOL NDU-LD-SCH

DISCLAIMER

This research report represents the views of the author and does not necessarily reflect the official opinion of the Industrial College of the Armed Forces, the National Defense University, or the Department of Defense.

This document is the property of the United States Government and is not to be reproduced in whole or in part for distribution outside the federal executive branch without permission of the Director of Research and Publications, Industrial College of the Armed Forces, 408 4th Avenue, Fort McNair, D.C. 20319-5062.

Abstract

This paper explores the continued viability and functional utility of the Federal Reserve System (Fed) as America moves into the 21st century and the peak of the information-technology age. Congress and the President established the Fed in the early twentieth century to ensure the availability of money and credit to fuel our rapidly expanding economy, and to bolster the country's confidence in the banking system. As the industrial age of America matured, the Fed evolved to support and contribute to our strength and dominance of the world's economy. The industrial age is waning and we are well into the technology-information age. Now is an excellent time to examine the Fed and streamline its operations. We can not maintain our world economic dominance without ensuring the optimal configuration of a major bulwark of America's financial infrastructure.

"The Fed, alas, by its very nature, is a tyrannical and secretive, self perpetuating bureaucracy. In its history it has all too often served as an enemy of freedom in America. There is much more at stake in the theories of 'monetarism' than a mere method of analysis of economic fluctuations."

Maxwell Newton¹

"By now virtually all economists, monetarist and Keynesian alike, are convinced that the money supply is a very important determinant of the level of aggregate demand. But not even its staunchest supporters believe that monetary policy, especially given the institutional structure within which it is implemented, is anything close to a panacea for the nation's problems with economic instability."

Harry D. Hutchinson²

Money is the vehicle of economies. It provides the means for establishing the value of goods, and subsequently transferring and storing that value.³ Economies manifest money in several forms and through history it has taken a variety of manifestations including coins of precious metals, shells, stones, and pieces of paper. It can take the form of a commodity such as gold or silver or it can be as exotic as the stone wheels of Yap. Money can be a claim on a commodity of value that is convertible on demand for the full value or a portion of the commodity; for many years the U.S. Treasury issued silver certificates that were readily exchangeable for silver coins. Most common today is fiat money, such as the Federal Reserve Notes we use. This currency has no value in itself but rather garners its faith in the solvency of the United States.⁴ A fourth form of money is quickly evolving in America and throughout the world--electronic money. Many modern transactions occur without any physical paper exchanged. This enduring presence of money stresses its importance in facilitating the functioning of economies.

To ensure the effectiveness of America's monetary system in supporting the fundamental purposes of measure, transfer and storage of value, the Federal Reserve System sets monetary policy to regulate the economy through actions on the money supply. This policy serves to adjust the availability of money, more specifically the rate of growth of the supply and the interest rates associated with borrowing. Economist Allan Meltzer summarizes the difficulties of monetary policy:

The spending boom, the return of inflation and high interest rates, and later the onset of recession show the familiar monetarist associations of money growth with inflation and high interest rates, unanticipated increases in money growth with booms, and unanticipated reductions of money growth with recessions.⁵

Although the Fed's policy has been arguably effective during America's industrial growth of the twentieth century, it now is less flexible because of the adverse effects of the federal deficit and the increased interrelationships of the global economy.

Another way of viewing money is that it represents human effort. Initially, it represented the brute force needed to wrench resources from nature. Then society advanced so that it reflected human skill and ingenuity to harness other elements of nature and reduce the muscle element. Finally, we've advanced to brain power in producing intellectual properties. And complementing producer activity is the consumer. People use their earned dollar to obtain the right to harness and consume the fruits of the physical and mental labors of others. Beyond the use of money to establish, transfer and store value, it exists in an entirely different form--it is a commodity in itself, a resource used to fuel growth through interest bearing (usually)

loans to purchase means for bringing more material to the market place. So, in order for the economy to function, to unite the producer and the consumer and to fuel our economic growth, we have a monetary system, both at the domestic level and on a global scale.

In modern countries the monetary system is generally supervised by government and is a foundation of an economy's viability. Noted economist Milton Friedman points out, "The failure of government to provide a stable monetary framework has thus been the major if not the major factor accounting for our really severe inflation and depressions."⁶ In America, Congressional legislation mandates and empowers our central bank, the Federal Reserve System (Fed) to accomplish this. Through intermittent alterations, the Fed has evolved to its current role. Unfortunately, historical improvements to the system are becoming more difficult to implement. Today, we function with a central bank evolved from an agricultural economy. Our monetary system hasn't yet advanced to the level of the technology-information age and the demands of a highly integrated global economy.

At the heart of our economy's finances sits the Federal Reserve System. This rich, powerful, quasi-governmental entity wields power over all aspects of our banking and finance industry. With its origins at the beginning of America's advance to dominance among industrialized countries, the Fed has been an active partner in America's growth. However, economic evolution and technological advance raise

questions about the Fed's current responsibilities. It is argued that many functions could be easily accomplished by private industry or elsewhere in other public agencies or private organizations. An in-depth look at the Fed's compensation provides a starting point for understanding why it is time to consider restructuring.

Our monetary base must be large enough to provide the necessary amount of money to suit our needs, specifically economic growth. Our money flows through a variety of markets--the banking system administered by the Fed, as well as capital financial markets composed of government and corporate securities, mortgages, and common stocks; money markets involving short term government and commercial paper, federal funds, and other negotiables; and a variety of other sectors composed of various derivatives including options, futures and exotics of the financial world. The arena is further complicated by the presence of insurance companies, finance corporations, investment entities (mutual funds) and pension funds.⁷ With the industrial revolution now past its zenith and the information age a blazing comet in the global economic sky, America must launch itself into the 21st century structured to sustain our dominance as the leading world economy.

Structure of the Fed

The Federal Reserve System consists of 12 geographic regions encompassing the entire United States. Each of these has a federal reserve bank (FRB) responsible for

the region. A board of governors oversees each FRB. The nationally chartered banks in each region are the technical owners of the FRB through a special form of stock and have a role in selecting two-thirds of the governors for their FRB (the remaining third is appointed by the Federal Reserve Board of Governors in Washington). Though in the event of the system was dissolved the Fed's assets would revert to the Treasury. Each FRB is responsible to what is essentially its parent holding company, the Federal Reserve Board of Governors, headquartered in Washington, DC. Seven governors are appointed to the Federal Board of Governors by the President of the United States and confirmed by the U.S. Senate for 14 year terms. Legislation prohibits appointment to successive full terms. The chairman and vice chairman undergo the same appointment and confirmation process for terms of four years. They may come from within the board or be appointed and confirmed simultaneously to a governorship.

Although the Fed's charter makes it formally independent of the federal government, it nonetheless remains intimately tied to the government. Federal law regulates and dictates the operations of the Fed--these laws are changeable. The Fed maintains an ongoing dialog with both Congress and the Executive Branch regarding its activities. Harry Hutchinson's description of the independence and political concerns of the Fed best sum up its peculiar status in the federal bureaucracy.

The Board of Governors is a strictly governmental agency concerned solely with the public interest. It does, however, maintain a unique status among governmental agencies in that it is, to a degree, insulated from and independent of much of the direct control by the president and Congress to which most other governmental agencies are subject.

The 14-year terms, for example, guarantee any member a tenure in office of longer duration than that of the president who makes the appointment. A member of the Board of Governors, not unlike a federal judge, may only be removed from office before the end

of his or her term for "cause." Once appointed, he or she does not--as do Cabinet members and other high officials--serve at the pleasure of the president. Consequently, in case of a difference in policy views, a Federal Reserve governor is free to pursue a monetary policy to which the president may be opposed without fear of reprisal.

In addition to this degree of protection from control by the executive, the Board of Governors also possesses an element of independence from legislative dictation that most other government agencies lack. This should certainly not be interpreted as implying that the Federal Reserve is *totally* independent of Congress. The Federal Reserve System was established by congressional action, and its structure, powers, and indeed its very existence are subject at all times to the legislative will.

Within the confines of existing law, however, the Federal Reserve System possesses a unique freedom from congressional pressures simply because it earns its own income. Congress's power over the purse strings is, of course, among its most basic instruments of control.⁸

The governors also form the core of the Fed Open Market Committee (FOMC). Membership also includes representation on a rotational basis from 5 of the 12 FRBs. The Federal Reserve Bank of New York has a unique position as a permanent member of the FOMC because of its responsibilities for conducting transactions on the financial markets for the Fed.

Functions of the Fed

The Federal Reserve System was founded in 1913 following the tragic collapse in 1907 of the financial infrastructure of America's banking system. The Federal Reserve Act of 1913 established the Fed and prescribed its responsibilities as, "To provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes." These responsibilities have progressively evolved in the 82 years of the systems history and are, in some ways, significantly

different from the Fed's original charges. Today the Fed's responsibilities encompass four major realms of involvement in America's monetary system.⁹ They encompass routine financial services, supervision and regulation, stabilizing the banking system, and formulation and implementation of America's monetary policy. This evolution has followed the transformation of America and the world from the agricultural age into the industrial age. What isn't clear is whether the continued metamorphosis of the structure and its responsibilities will support America's continued growth and leadership in the technology-information age. Nonetheless, the Fed is the largest central bank in the world with nearly a half- trillion dollars in assets and a net worth of over \$7.5 billion.¹⁰ A brief overview of the Fed's operations shows the expanse of its control and integration into the American economy.

Financial Services. The most routine responsibilities are the Fed's financial services to the banking industry, the public, official foreign agencies, and the U.S. government. These are essentially activities of being a bank to the nation's banking system, the federal government (*i.e.*, Treasury), and foreign governments and their agencies. As the bank for the Treasury, the Fed handles all monetary transactions to and from the federal government. These include international transactions, disbursements from the Treasury's account at the Fed, and deposits consolidated from a vast network of federal deposit accounts at commercial banks. On rare occasion the Fed conducts unique transactions with the central banks of other countries, as the Treasury's agent, to intervene in "propping" up the American dollar. This seldom occurs, though there have

been several instances within the past year--an anomaly when viewed historically. There is no doubt of the importance of this act in sustaining confidence in our country's economic tender, but remember the Fed takes this action as the agent for and under the direction of the Treasury. Some of the more mundane financial service operations of the Fed include clearing operation for checks, electronic transfers, holding deposits for foreign governments, and facilitating the transfer of coin and currency supplies to replenish the needs of banks.

Oversight and Regulation. The Fed's oversight of the banking industry involves a variety of regulatory duties over state chartered banks, their foreign branches and their holding entities, foreign banks operating branches in the United States, and other banks holding membership in the Federal Reserve System, and establishment of the margin limits on securities transactions. The Fed's responsibility includes examination for determining the ability of a bank to continue sound operation. In essence the Fed firmly holds the reigns, directly or indirectly, to a majority of the banking industry, and its influence reaches much further into the financial world. However, there is significant overlap in many of these responsibilities with state regulatory agencies, the Treasury, the Federal Depository Insurance Corporation, and numerous other governmental entities (see Table 1). Interagency oversight is coordinated by the Federal Financial Institutions Examination Council (FFIEC). Founded by federal legislation in 1978, the council is composed of the Chairpersons of the FDIC and the National Credit Union

Administration, the Comptroller of the Currency, the Director of the OTS, and a Governor of the Federal Reserve Board appointed by the Board Chairman.¹¹

Table 1: Federal supervisor and regulator of corporate components of banking organizations in the United States¹²

<i>Component</i>	<i>Supervisor and Regulator</i>
Bank holding companies	FR
National banks	OCC
State banks	
Members of Federal Reserve System	FR/SG
Non members	FDIC/SG
Cooperative banks	FDIC/FR
Industrial banks (if insured) ^a	FDIC
Section 20 affiliates	SEC/FR
Thrift holding companies	OTS
Savings banks	OTS/FDIC/FR
Savings and loan associations	OTS
Edge Act and agreement corporations	FR
Foreign banks ^b	
Branches and agencies ^c	
State licensed	FR/FDIC/SG
Federally licensed	OCC/FR/FDIC
Representative offices	FR

Notes: FDIC: Federal Deposit Insurance Corporation
 FR: Federal Reserve
 OCC: Office of the Comptroller of the Currency
 OTS: Office of Thrift Supervision
 SEC: Securities and Exchange Commission
 SG: State government

- a. Uninsured industrial banks are supervised by the states.
- b. Applies to direct operations in the United States. Foreign banks may also have indirect operations in the United States through ownership of U.S. banking organizations.
- c. The FDIC has responsibility for branches that are insured.

Source: Federal Reserve

Banking System Stability. The Fed's original task to rediscount commercial paper evolved to ensure banks maintain the necessary solvency through adequate reserves. This ensures the banking system remains stable and sustains the public's confidence

and trust as a repository of private and commercial deposits. The Monetary Control Act of 1980, requires all depository institutions to maintain specific reserve funds as a proportion of the balances in certain deposits. These reserves are either cash in the vaults of the institutions or are deposits with the Fed. Reserve requirements are 8 to 14 percent of transactions deposits which involve demand deposits (available for immediate withdrawal) and certain interest-bearing accounts with unlimited checking privileges. Nonpersonal time deposits have reserve requirements of 0 to 9 percent depending on their maturity. There is a graduated scale to ease the reserve requirements on small institutions. In 1994 the first \$4 million of reservable deposits was exempt, up to \$51.9 million required 3 percent reserves, and above this level the reserve requirement was 10 percent.¹³ A complex averaging system computes required reserve levels and balances. When a institution does not have the necessary reserves then it must seek excess reserves (federal funds) from another institution, or if unsuccessful in that quest may then borrow from the Fed discount window ("last resort").

The discount window lending evolved from the original activity of the Fed loaning reserves to banks on commercial paper collateral. Today, discount window operations are limited and have been eclipsed by the overnight inter bank federal funds lending.¹⁴ As explained later, this system of reserves is the major element in the Fed's influence on America's economy. This direct influence was not originally intended. The intention was to make sure that during periods of a slumping economy, there was adequate

money and credit available for the economy and the banking system to continue to function. To this end the Fed represented a source of last resort for credit to maintain necessary reserve levels, ensure continued confidence in the banking system, and maintain adequate credit and money for the economy to continue to function. This founding responsibility was last exhibited in the 1987 deterioration of the stock market when Fed actions precluded financial panic and potential disaster.¹⁵

Monetary Policy. Reserves play the key role in influencing the amount of money in the economy. This is achieved through three different tools empowered to the Fed. The first is setting the discount rate (Fed to bank) for loans to maintain required reserve levels. This indirectly relates to the federal funds (bank to bank) loan rate involving excess reserve transactions between member banks. The discount rate and its partner the federal funds rate are the shortest of loan rates. These loans are typically overnight transactions conducted by banks to meet the reserve requirements of Fed regulations.

Discount rate adjustment is the more publicized action of the Fed and is a routine topic of discussion in the media--either speculating the next move of the Fed or critiquing the last move. Frequently the Fed's adjustment of the discount rate is erroneously reported as a change to the federal funds rate. The fed funds rate fluctuates as it is negotiated between the lending and borrowing banks. More influential in adjusting the money supply is the Fed's open market operations. Beginning in the 1920s, these operations have followed a variety of principles in their utilization. While

open market operations (OMO) are large scale, frequent, and influential, they are seldom reported in the media and not well understood by the public. In OMO, the Fed conducts transactions on its secondary market holdings of \$350 billion in U.S. federal debt. Through purchases (increasing the money supply) or sales (reducing the money supply) of debt instruments to its members banks, the Fed adjusts the monetary base in America to influence primarily price stability (inflation) and secondarily unemployment. According to monetary theory the direction of change in these two outcomes is a fairly predictable inverse relationship over time.

Value of the Fed. In addition to the economic and societal benefits from the operation of the Federal Reserve System, it has the added benefit of generating a financial surplus from operations. Proceeds come from interest on securities, foreign currency operations, banking fees, and loans. The system pays all its expenses (though it has no traditional business tax liabilities), a six percent dividend to member banks for their capital contribution, and returns its surplus to the federal government. Historically, the Fed has paid 95 percent of its net earnings into the Treasury.¹⁶

Throughout its 82 years of history, the Federal Reserve System has been a strategic asset to the growth and security of the United States. Today it still has benefits though the system is ripe for restructuring to ensure its continued strategic value to our country in aiding our global economic growth and leadership. In fiscal terms the system is a distinctive asset to the federal government. In 1995, the Fed

generated revenue of roughly \$25 billion (primarily interest payments by the Treasury on bonds held by the Fed), and returned over \$23 billion of that to the Treasury.¹⁷ Certainly not a sum to offset the federal deficit but it does contribute to lessening it. Clearly, the Federal Reserve System's involvement in the American economy is valuable and in the interest of our economic prosperity and continued national security.

The U.S. Economy and the Fed

In the American economy, the Fed works to regulate our economy through adjustment of the monetary base that fuels the economy. This is done through three actions centered on bank reserves: discount loans to banks (including the rate of those loans) to maintain required reserves; setting reserve requirements; and open market operations to adjust actual reserve levels and, hence, the size and growth rate of the monetary base. The first two actions--discount rate and reserve levels--have little involvement in current monetary policy. The discount rate serves more as a marker and signal of where the Fed sees current short term rates and is frequently more a response to the market than a driver.¹⁸ Rates are adjusted more to keep them in alignment with market rates.¹⁹ Altering reserve requirements by the Fed is restricted by legislation to emergency situations and requires the permission of the U.S. president. Hence, the Fed functions primarily by adjusting the monetary base through open market operations.

Open Market Operations. The Fed conducts open market operations through secondary market transactions of U.S. government securities to influence total reserve levels (and secondarily interest rates).²⁰ Utilizing reserves, the Fed can raise the monetary base by purchasing securities. This shifts cash money out of the Fed and into circulation. Purchasing of securities increases their demand, raises their price, and lowers their interest rate. The additional money supply should make credit cheaper and easier to obtain. This in turn should raise consumer demand and spending. Conversely, Fed selling of securities lowers their demand, raises their yield, withdraws cash from circulation, and should ultimately raise interest rates. The Fed conducts open market operations with great care in order not to make any dramatic shift in the delicate equilibrium that could trigger either inflation or recession.

As the Fed makes adjustment to the monetary base through open market operations, the Treasury is simultaneously acting upon it through fiscal policy manifest in federal debt management operations, taxation and spending. Donald L. Losman and Shu-Jan Liang summarize the interrelation of Fed and government policy, "Clearly, both monetary and fiscal policy have important contributions to make to economic stability. In the opinion of most economists, to be successful these policies need coordination rather than running at cross currents."²¹ Unfortunately, in practice this has not always been the case, "...institutional enthusiasm for expansionary policies during recessions... is not matched by a taste for contractionary policies during booms."²² This circumstance better describes America's fiscal policy in recent decades--we have

eagerly employed expansionary fiscal policy when needed but failed to tighten fiscal policy when restraint was appropriate. Unfortunately the large federal debt generated by past lax fiscal policy, reduces potential of America's monetary policy today.²³ In order to restore fiscal and monetary flexibility in the future, America must decrease its deficit spending. "The Congress and the Administration still must deal with some difficult issues to ensure that the deficit is kept on a downward course through the latter part of the 1990s and into the next century."²⁴ Looking back at the fiscal and monetary activities from the late 1970s provides insight into how our present plight was created.

Monetary Policy in the 1970s and 1980s. The 1970s and early 1980s were a notably frustrating period for the Fed. Table 2 shows high inflation predominated during periods of rapid growth in the monetary base. During the late 1970s the Fed pursued an expansionary policy allowing significant growth in the money supply resulting in moderately high inflation. This triggered the "double dip"--two consecutive recessions without intervening growth--of 1979-80 and 1981-82.²⁵ During this same period fiscal policy became more constrained following the major budget deficits of 1975-76. By the beginning of the 1980s this situation shifted to its mirror image with constrained monetary policy and an expansionary fiscal policy. This change brought inflation down in the mid 1980s but it returned in 1990.²⁶

The problems of the 1979-82 period are popularly attributed to the Fed's lack of attention to interest rates. During that period monetary policy was tied solely to the

monetary base and interest rates were left to be set entirely by the market. The result was significant volatility in rates through a period of two recessions. By 1982 the Fed abandoned this approach as unsuccessful.²⁷

Table 2: U.S. Money Growth and Inflation (compound annual rates in percent)²⁸

	<i>Money Growth</i>	<i>Inflation</i>
1960-64	2.8	1.6
1965-69	4.9	3.7
1970-74	6.0	6.0
1975-79	6.9	7.9
1980-84	6.6	7.3
1985-87	7.2	3.5
1987-91	4.4	3.8

Source: Allan H. Meltzer, "Monetarism"

Monetary Policy in the 1990s. The United States economy experienced a moderate recession during 1990 and 1991. Subsequently, the recovery gained momentum in 1992, though progress was fitful at times. Since then, growth generally remains near two and a half percent or better, which matches or exceeds the historic U.S. average. As large and complex as our economy is, its strength is necessarily a result of myriad factors. Actions by the Federal Reserve in influencing interest rates and adjusting the monetary base play prominently in the state of the economy. Recent Fed policy is summarized as, "With success in keeping the economy on course toward the long-run

goal of price stability, the prospects for sustained expansion will be greatly enhanced."²⁹ In concert with the Fed's concern for low inflation (price stability) and economic growth (sustained expansion) it is attentive to employment levels. To this end, the Fed maintained relatively low interest rates during the early 1990s.³⁰ Through 1992 and early 1993, the Fed began to see indications of the economy expanding with inflation restrained. During this period the Fed shifted its targeting procedures to a greater dependence on inflation adjusted interest rates over monetary measures.

By late 1993 and into early 1994 the Fed saw conditions improving significantly with major reductions in excess industrial capacity and unemployment. At this point, in order to preclude increased inflationary pressure, the Fed progressively raised interest rates. Harry D. Hutchinson summarizes the influence of these activities on our economy:

For years it was popular to sum up the relative effectiveness of monetary policy in recession and inflation with that overworked cliché: 'You can pull on a string but you can't push on it.' The obvious inference, of course, was that monetary restriction to counter inflation has more chance of success than does monetary ease to combat recession.³¹

We may be seeing this in the current economy where inflation is under control at levels around three percent and unemployment is at the generally considered low level of around five and a half percent. With unemployment at essentially its lowest practicable level, any effort to boost growth will be inflationary. Weil sums it up as, "If the economy is at full employment, by contrast, a fiscal expansion will have more effect on prices and less impact on total output."³² What America faces today is there isn't any "room to maneuver."

Strategic value of the Fed

The Federal Reserve System typifies the federal bureaucracy's reluctance to promptly adjust itself to changes in the world. In particular the Fed's presence may no longer be necessary in activities it pioneered but which are now routine. Some Fed functions no longer require government to get them done, while others could be placed elsewhere in the government to streamline processes, reduce redundancy, and ensure the Fed's focus on maintaining a healthy economy and a sound banking system.

Check and Cash Handling. The business of check clearing has been handled by the Fed to ensure the prompt exchange of funds between banking institutions. America needed the Fed to do this as the nation and its economy rapidly grew and expanded. Check clearing was a particularly important aspect of the monetary system when communications and transportation were slow and costly. With technological advances this niche service has evolved into an industry sector of its own. The Fed involvement is dwindling and now represents less than 35 percent.³³ Regulations mandate that the Fed operate this service on a pricing par with commercial sources to preclude unfair advantage. Technology will eventually render it obsolete and even the current Fed operation is handled to a great extent through contract service. Although a small piece of the pie, transfer of this service to the private sector would accomplish one more step in reducing the federal bureaucracy. The banking industry should provide this service

through its own associations or joint ventures. Private enterprise has already demonstrated the ability to function in this sector.

Likewise, the distribution of coin and currency could be handled via alternate channels utilizing contract operations by the growing national banking corporations, just as they could handle the federal treasury banking operations. Yet, the magnitude of this responsibility could prove too costly, cumbersome or risky for any other organization to perform. The Fed with its established regional banks and their branches may be best positioned to continue this monumental task. As the utilization of electronic funds increases, cash handling may decline to a level that could be handled by alternative means or organizations. What can't be transferred is the development and implementation of America's monetary policy.

Monetary and Fiscal Policy. As pointed out previously, the twin elements of American economic policy monetary and fiscal policy, are currently severely handicapped. Government is virtually paralyzed in its ability to exercise fiscal policy. Service costs on the huge federal debt continue to reduce the discretionary portion of the budget. This is the area where fiscal policy generally operates. With this tool so impaired, the emphasis shifts to monetary policy. It too is handicapped by the huge deficit--specifically because the global bond ownership of America's debt places a premium on maintaining low inflation (and thereby maintaining the face value of bonds). Clearly any fiscal or monetary policy actions that intimate lack of restraint in the management of

federal debt or which could prove inflationary will panic the bond market.³⁴ Hence, America must tread carefully. The errors of the late 1970s and early 1980s could be particularly devastating if repeated. Congress and the Executive Branch must continue to pursue a course to bring the federal budget into a net balanced condition and the Fed must be particularly cautious in executing its monetary policy. Milton Friedman describes the difficult challenge of proper and effective monetary policy:

What we need is not a skilled monetary driver of the economic vehicle continuously turning the steering wheel to adjust to the unexpected irregularities of the route, but some means of keeping the monetary passenger who is in the back seat as ballast from occasionally leaning over and giving the steering wheel a jerk that threatens to send the car off the road.³⁵

There is opportunity for improvement in the Fed's handling of monetary policy. One criticism is the lack of publicly set, publicly visible targets for the Fed's regulation of the money supply.³⁶ What's the measure of their achievement of specific goals and the justification for their goals? Although the German economy functions differently than America's, the *Bundesbank* historically maintains low inflation. It sets monetary growth rates and generally maintains them. This adherence to targets instills significant consumer and producer confidence in the *Bundesbank* and hence the German economy.³⁷ The Fed needs to be encouraged, if not required, to establish timely and visible goals for their actions and then be evaluated relative to their achievement.

Oversight and Regulation. As pointed out previously, the Fed's origin was in response to the 1907 banking crisis. Although there are examples of problems in America's banking system since then, most notably the recent savings and loan

debacle, U.S. banking enjoys a history of stability and strength. Whether or not to give some credit for success to the oversight of the Fed is a difficult question to answer. As previously presented, Table 1 shows the extensive oversight of the system by a number of federal and state agencies. Milton Friedman raises an interesting point about the placement of this responsibility for oversight, "Control over monetary and banking arrangements is a particularly dangerous power to entrust to government because of its far reaching effects on economic activity at large--as numerous episodes from ancient time to the present and over the whole of the globe tragically demonstrate."³⁸ In the current trend of deregulation, the question arises as to the need for the continued duplication of oversight activities. It also raises the question of whether the Fed should be involved in oversight while it simultaneously is America's monetary policy institution. Charles Goodhart and Dirk Schoemaker investigate this very question, "[W]hether the combination of monetary and regulatory functions under one roof leads to conflicts of interest; in particular whether concerns for micro-level health and stability of (parts of) the banking system might distort a central banks conduct of monetary macro policy."³⁹

Careful examination by Goodhart and Schoemaker of separation versus union of monetary policy and banking oversight throughout the world found a roughly equal distribution of the two options. America is difficult to classify with our hybrid system. Although the Fed is clearly the monetary policy maker, it is not the sole nor exclusive regulator of the banking system. Interestingly a potentially similar conflict of interest could be posed to exist with the FDIC. Their oversight could be tainted by their

responsibility to rescue institutions identified as in peril or placed in jeopardy by regulatory changes. In theory the extensive involvement of numerous agencies in the banking oversight system provides additional perspective and increased probability of detecting problems. It provides verification from independent agencies, while troubled entities receive greater oversight through increased monitoring by all involved organizations.

Goodhart and Schoemaker found that both separate and merged oversight and monetary policy approaches were effective, and that the roughly even division between the two options was itself a statement of near equal value of either system. They concluded the choice between the alternatives was best based on the structure of government and the banking system coupled with the means to rescue problem institutions in a particular country.⁴⁰ For America the question remains--despite our success--do we have an unnecessarily costly duplication of effort?

This discussion has pointed to just a few of the many aspects of America's Federal Reserve System. Since its birth early in the second decade of this century, the Fed has undergone numerous changes. Unquestionably it is an important and integral part of America's economic system. The continued growth and evolution of our economy mandate that the Fed also continues to be in constant change to keep pace. The challenges of the info-technology age make continuous improvement to the structure and operation of the Fed ever more important and relevant.

Conclusion

Now more than ever the United States is modernizing and reorganizing to bolster our position as the leader of the global economy. We have suffered and still suffer in some aspects from industrial stagnation, economic disparity in the population, disappointing education and training, sluggish productivity improvement and a general public malaise. As we progress through improving these we find wholesale changes in industry, marked revisions in the structure, roles and functioning of our federal government, challenges to improve the educational system, rejuvenation in the faith of the American worker and people, and advances in our strategic goals. Through all of this a stable monetary system will ensure America's continued dominance of the global marketplace.

As America moves into the 21st century we must ensure the responsiveness and flexibility of the Federal Reserve System in keeping our monetary policy system in synch with the information age. The Fed has long since passed its original purpose of ensuring the stability of America's banking system. We need to closely examine the functions the Fed is tasked with and ensure it is not needlessly burdened with responsibilities that impede its focus on its most important responsibility of monetary policy. Of utmost importance is for America to ensure the Fed's flexibility in exercising an effective monetary policy. To this end, Congress and the Executive Branch must resolve deficit spending and place America on a firm program leading to net balanced

budgets. This is the ultimate solution to restoring vitality and versatility to America's economy, the full capability of the Fed to exercise monetary policy, and the political system to similarly employ effective, responsive and responsible fiscal policy.

Notes

- ¹ Newton, *The Fed*, viii.
- ² Hutchinson, *Money, Banking, and the United States Economy*, 446.
- ³ *Ibid.*, 4.
- ⁴ Baumol and Blinder, *Economics: Principles and Policies*, 719.
- ⁵ Meltzer, "Monetarism," 133.
- ⁶ Friedman, *A Program for Monetary Stability*, 9.
- ⁷ Hutchinson, *Money, Banking and the United States Economy*, 39.
- ⁸ *Ibid.*, 119.
- ⁹ *The Federal Reserve System: Purposes and functions*, 1,2.
- ¹⁰ *Ibid.*, 114.
- ¹¹ *Ibid.*, 73.
- ¹² *Ibid.*, 73.
- ¹³ *The Federal Reserve System: Purposes and functions*, 54.
- ¹⁴ Tobin, "Monetary Policy," 275.
- ¹⁵ Baumol and Blinder, *Economics: Principles and Policies*, 746.
- ¹⁶ *The Federal Reserve System: Purposes and functions*, 12.
- ¹⁷ Federal Reserve Board of Governors, February 23, 1996.
- ¹⁸ Tobin, "Monetary Policy," 275, 276.
- ¹⁹ Baumol and Blinder *Economics: Principles and Policies*, 746.
- ²⁰ Friedman, *A Program for Monetary Stability*, 24.
- ²¹ Losman and Liang, *The Promise of American Industry*, 80.
- ²² Weil, "Fiscal Policy," 260.
- ²³ Tobin, "Monetary Policy," 274.
- ²⁴ *The Federal Reserve System: Purposes and functions*, 202.
- ²⁵ Tobin, "Monetary Policy," 272.

- ²⁶ Heath *et al.*, "Monetary and Fiscal Policy in the 1980s," 138.
- ²⁷ Tobin, "Monetary Policy," 276 278.
- ²⁸ Meltzer, "Monetarism," 129.
- ²⁹ *Monetary Report to the Congress*, 202.
- ³⁰ *Ibid.*, 202.
- ³¹ Hutchinson, *Money, Banking and the United States Economy*, 446.
- ³² Weil, "Fiscal Policy," 258.
- ³³ Knight, "The Check is in the airmail." F2.
- ³⁴ Sease, "The Vigilantes," A1.
- ³⁵ Friedman, *A Program for Monetary Stability*, 23.
- ³⁶ Hutchinson, *Money, Banking and the United States Economy*, 64.
- ³⁷ Meltzer, "Monetarism," 131.
- ³⁸ Friedman, *A Program for Monetary Stability*, 4.
- ³⁹ Goodhart and Schoemaker, "Should the Functions of Monetary Policy and Banking Supervision Be Separated?" 540.
- ⁴⁰ *Ibid.*, 555, 556.

Bibliography

- Baumol, William J. and Blinder, Alan S. *Economics: Principles and Policies*. Fort Worth: The Dryden Press, 1994.
- Berry, John M. "Blinder to Leave Federal Reserve." *Washington Post* January 17, 1995: F1.
- . "The Loan Reason that Economic Growth is Sluggish." *Washington Post* February 1, 1996: D9.
- Cooper, James C. "Looking for an Excuse, Greenspan finds the Greenback." *Business Week* Nr. 384 (August 8, 1994): 25.
- Dabbs, Russell. "The U.S. Economic Outlook: It looks better, but is it cured?" *Survey of Business* 30, Nr. 1 (Winter, 1995): 16-24.
- Drucker, Peter F. *Post Capitalist Society*. New York: Harper Business, 1994.
- Economic Report of the President*. Washington: U.S. Government Printing Office, 1995.
- The Federal Reserve System: Purposes and Functions*. Washington: Board of Governors of the Federal Reserve System, 1994.
- Forsyth, Randall W. "Current Yield." *Barron's* 74, Nr. 5 (January 31, 1994): 60, 61.
- Friedman, Milton. "Using Escalators to Help Fight Inflation." *Fortune* 90, Nr. 1 (July 1974): 94-97, 174-176.
- Goodhart, Charles and Schoemaker, Dirk. "Should the Functions of Monetary Policy and Banking Supervision Be Separated?" *Oxford Economic Papers* 47, Nr. 4 (October 1995): 539-560.
- Greenspan, Alan. "The Federal Reserve and Monetary Policy: A stable platform for business." *Vital Speeches of the Day* 61, Nr. 17 (June 15, 1995): 514-516.
- Greider, William. *Secrets of the Temple: How the Federal Reserve Runs the Country*. New York: Simon and Schuster, 1987.
- Heath, Daniel *et al.* "Monetary and Fiscal Policy in the 1980s." In *Defense Economic Issues*. Edited by Hugh Conway. Washington: National Defense University, 1990.

Hutchinson, Harry D. *Money, Banking, and the United States Economy*. 6th ed. Englewood Cliffs: Prentice Hall, 1988.

"In a Fix At the Fed." *Business Week* Nr. 430 (June 26, 1995): 34, 35.

Kennedy, Paul. *The Rise and Fall of the Great Powers: Economic Change and Military Conflict from 1500 to 2000*. New York: Vintage Books, 1989.

Knight, Jerry. "The Check is in the Airmail." *Washington Post* January 17, 1996: F1.

Krugman, Paul. *The Age of Diminished Expectations: U.S. Economic Policy in the 1990s*. Cambridge: MIT Press, 1995.

Losman, Donald L. and Liang, Shu-Jan. *The Promise of American Industry: An Alternative Assessment of Problems and Prospects*. New York: Quorum Books, 1990.

Meltzer, Allan H. "Monetarism." In *The Fortune Encyclopedia of Economics*. Edited by David R. Henderson. New York: Warner Books, 1993.

"Monetary Policy and the Economic Outlook for 1995 and 1996: Excerpts from Alan Greenspan's presentation to Congress." *Business Credit* 97, Nr. 9 (September 1995): 36.

"Monetary Policy Report to the Congress." *Federal Reserve Bulletin* 79, Nr. 9 (September 1993): 827-845.

"Monetary Policy Report to the Congress." *Federal Reserve Bulletin* 80, Nr. 3 (March 1994): 199-219.

"Monetary Policy Report to the Congress." *Federal Reserve Bulletin* 80, Nr. 8 (August 1994): 681-701.

"Monetary Policy Report to the Congress." *Federal Reserve Bulletin* 81, Nr. 3 (March 1995): 219-243.

"Monetary Policy Report to the Congress." *Federal Reserve Bulletin* 81, Nr. 8 (August 1995): 219-243.

Naisbitt, John. *Global Paradox: The Bigger the World Economy, the More Powerful Its Smallest Players*. New York: William Morrow and Company, Inc., 1994.

Newton, Maxwell. *The Fed: Inside the Federal Reserve, the Secret Power Center that Controls the American Economy*. New York: Times Books, 1983.

Nye, Joseph S., Jr. *Bound to Lead: The Changing Nature of American Power*. New York: Basic Books, 1991.

"Progress Toward Price Stability: A report card for 1994." *Economic Review* (Federal Reserve Bank of Kansas City) 80, Nr. 1 (First Quarter, 1995): 5-18.

Rose, Sanford. "The Agony of the Federal Reserve." *Fortune* 90, Nr. 1 (July 1974): 90-93, 180-190.

Schwartz, Anna J. "Money Supply." In *The Fortune Encyclopedia of Economics*. Edited by David R. Henderson. New York: Warner Books, 1993.

Sease, Douglas R. "The Vigilantes: World Bond Buyers Gain Huge Influence Over U.S. Fiscal Plans." *Wall Street Journal* November 6, 1992: A1, A6.

Tobin, James. "Monetary Policy." In *The Fortune Encyclopedia of Economics*. Edited by David R. Henderson. New York: Warner Books, 1993.

Volcker, Paul A. "Sustaining Economic Growth: Progress Toward Stability." *Vital Speeches of the Day* 60, Nr. 13 (April 13, 1994): 392-395.

Weil, David N. "Fiscal Policy." In *The Fortune Encyclopedia of Economics*. Edited by David R. Henderson. New York: Warner Books, 1993.

Woodward, Bob. "President and the Fed Forge New Relationship." *Washington Post* June 6, 1994: A1.